Fiscal policy and the India growth story

PUBLIC INTEREST

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In recent months many have commented on fiscal policy and the India growth story. I shall focus on two "big" growth questions that impact fiscal policy. A single budget can do little to address these, but, in my view, this is a more productive exercise than wittering on about how the budget can provide a growth stimulus.

First, the growth rate is falling. Why is growth falling? Is consumption demand falling? Then prices should fall so demand increases. But this is not happening — inflation is above the Reserve Bank of India's target. If so, then the solution is for RBI to control inflation better. Surely, this should be the focus of policy attention, rather than crying for government to spend more?

If growth is lower because private investment is lower, then why is this the case? If this is just because demand is low and there is excess capacity, then the policy action required would be the same as the previous case. But some assert that investment is low because "sentiments" are low. If so, it is difficult to see how more government spending will help. Economic policy works through the head, not the heart, and retail therapy through increased government borrowing is not good policy in my view.

Some argue for "counter-cyclical" action of a "Keynesian" nature. I'm not impressed. As I have argued before,[1] no one has published a credible business cycle for India on which serious policy making can be based. India grows as fast as it can with exogenous shocks and institutional barriers impacting its growth. I do not see evidence of any exogenous shock yet, and I am not willing to call demonetisation such, as both government and the RBI assure us that any negative impact is temporary and will be counterbalanced by higher growth in the near future.

Even if we accept some vulgarisation of Keynes's general theory and apply it to India, the best way to do this would be to increase public expenditure financed by additional taxation — the "balanced budget multiplier". This would imply more expenditure, and a bigger state. I take no exception to this recommendation though the ability of any level of the government to sharply raise taxes is historically questionable. Government could also borrow and increase spending, but here we have a problem. The central government is already running a revenue deficit, the main driver of which is a high historic interest burden. Further increasing this to boost consumption would seriously jeopardise future fiscal sustainability.

If the government boosted investment it must be in real stuff — gross fixed capital formation (GFCF) — but the impact will be lagged compared to boosting government consumption spending. In any case, GFCF by government has been falling over time simply because there are very limited avenues for such spending as the repeated under-spending in departments like railways illustrates. And there is no point in borrowing to increase "investment" — to put equity into Air India or the nationalised banks, if the intention is to boost aggregate demand.

The second big concern about growth is that it has not benefitted the vast majority of Indians. The core problem here is that growth is spurred by the consumption and investment of the rich; we are an economy where a downturn in auto sales is used as an indicator of economic health.

There are two solutions to this problem. The first is structural, to employ more people at higher wages in more productive work and thereby increase growth. The second is to take money from the beneficiaries of growth and give to the rest. This is an old idea. The second theorem of welfare economics shows that once an economy has attained its desired growth rate, transfers to the losers financed by taxes on gainers will allow us to attain any desired income distribution. This is what fundamentally drives the "basic income" idea together with some other vague moral and ethical concerns. Many important people have commented on the feasibility of this idea from the point of view of affordability and the forthcoming economic survey will devote a chapter to this issue.

But what is being missed here is the fundamental policy choice. A few people will benefit more or less permanently from India's growth story while the rest will be helped by government intervention to get a basic income. Growth will not benefit them directly by improving their lives, but indirectly by government compensating them for losing out on India's growth story. The discussion between the proponents and opponents of this measure, on whether it is better or worse than MGNREGS and other forms of handout, is about how to compensate the majority who do not benefit from the growth story, not on how to make them part of it. Or on how to finance better public services, health, and education to enable future generations to become part of the growth story.

Inclusive growth is about enabling wider participation in the growth story, but the current if fiscal debate is about how to compensate losers using annual budgets. Since at least our Prime Minister seems to recognise the need for medium-term inclusive growth, it is time we focus more on inclusive medium term fiscal policy.

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[1] *Misleading stylised facts, Business Standard, August 4, 2016*